NATIONAL ASSOCIATION OF ATTORNEYS GENERAL

Proposed

Spring Meeting
March 26-28, 1995
Washington, D.C.

RESOLUTION

REVISIONS TO THE NATIONAL ASSOCIATION OF ATTORNEYS GENERAL VERTICAL RESTRAINTS GUIDELINES

WHEREAS, the Attorneys General, as chief law officers of their states, are the primary enforcers of the states' antitrust laws; and

WHEREAS, the Attorneys General also represent their states and the citizens of their states in federal antitrust litigation; and

WHEREAS, the National Association of Attorneys General adopted Vertical Restraints Guidelines on December 4, 1985 and revised those Vertical Restraints Guidelines on December 8, 1988; and

WHEREAS, the Chair of the Antitrust Committee invited all states to participate in a review of the 1988 NAAG Vertical Restraints Guidelines for the purpose of revising the Guidelines to update them to reflect intervening changes in the law and to state clearly the methodology of the Attorneys General for evaluating vertical restraints, and to clarify the types of evidence parties would be expected to produce in support of such restraints: and

WHEREAS, the proposed revisions to the NAAG Guidelines prepared by the Revisions Committee were released for public comment on November 9, 1994 at the direction of the Antitrust Committee; and

WHEREAS, all comments received were reviewed by the Revision Committee and taken into consideration in the preparation of the final version of the Guidelines; and

WHEREAS, the Antitrust Committee of the National Association of Attorneys General has considered the proposed revisions to the NAAG Vertical Restraints Guidelines and has determined that these revisions would improve the Guidelines and has therefore recommended them for adoption by the Association.

NOW, THEREFORE, BE IT RESOLVED THAT THE NATIONAL ASSOCIATION OF ATTORNEYS GENERAL:

1) Adopts these revised Vertical Restraints Guidelines as a statement of the general enforcement policy of the Attorneys General who comprise the Association, subject to the exercise of their individual prosecutorial discretion, and variations or supplementations to allow for variations in precedents among the federal circuits and differences in individual state or common law; and

2) Authorizes its Executive Director and General Counsel to transmit these views and Vertical Restraints Guidelines to appropriate members of the Administration, Congress, and other interested individuals and associations.

Abstains: Attorney General Dan Lungren

BACKGROUND STATEMENT

The Vertical Restraints Guidelines of the National Association of Attorneys General (NAAG) explain the general enforcement policy concerning vertical restraints of the Attorneys General. Individual Attorneys General may vary or supplement this general antitrust enforcement methodology in the exercise of their individual prosecutorial discretion or to account for differences in state antitrust laws and variations in precedents among the federal circuits. In most states, the Attorney General is the primary or exclusive public enforcer of state antitrust law. The Attorneys General also represent their states and consumers who live in their states in federal antitrust litigation.

Vertical restraints are arrangements among businesses operating at different levels of an industry, *e.g.*, between a manufacturer and a distributor, or between a wholesaler and a retailer. These restraints can govern the price or conditions at which firms may buy, sell or resell goods and services. These Guidelines provide a framework for state antitrust enforcers to evaluate vertical restraints and determine their legality and likely effect on competition. Because of the extraordinary diversity of vertical restraints, the Guidelines do not purport to define the legality of each type of restraint in every context.

The Guidelines are designed to serve three primary purposes. First, they are a framework for analyzing vertical restraints that relies on market realities and case law rather than speculation and pure theory. Second, they inform the business community of the substantive standards used by the Attorneys General to review and, when appropriate, challenge vertical restraints. Finally, they articulate the analytical methodology the states will apply in determining whether a particular restraint is unlawful.

The primary purpose of the revision process was to state clearly the states' methodology for evaluating vertical restraints, to clarify the types of evidence the states would use when evaluating non-price restraints under the rule of reason, to adopt market definition methodology consistent with the methodology set forth in the Horizontal Merger Guidelines of NAAG adopted on March 30, 1993, and to underscore the primacy of facts over theory in vertical restraints analysis.

On January 23, 1985, the United States Department of Justice issued its Vertical Restraints Guidelines. These Guidelines were cast in terms of enforcement policy, although the Justice Department had not challenged Vertical Restraints for five years prior to the issuance of those Guidelines. NAAG first issued Vertical Restraints Guidelines on December 5, 1985. In 1988, the Guidelines were revised to reflect recent developments in the case law governing vertical restraints. In 1993, the United States Department of Justice withdrew its Vertical Restraints Guidelines at the same time it began to increase enforcement resources devoted to challenging vertical restraints. Because of US-DOJ's withdrawal of its Vertical Restraints Guidelines, and because of changes in case law, all states were invited to participate in a NAAG Guidelines Revision Committee, co-chaired by Assistant Attorney General Kevin J. O'Connor, Wisconsin, and former Assistant Attorney General Beth Farmer, New York. Ten other states participated as members of the committee: Arizona, California, Connecticut, Maryland, Ohio, Pennsylvania, Texas, Virginia and Washington.

The DOJ Vertical Restraints Guidelines, withdrawn by Assistant Attorney General Anne K. Bingaman in August 1993, were commonly understood to be a "political" document, designed to move the law in a particular direction. NAAG's 1985 and 1987 Guidelines were an attempt to state the law as it was understood at the time. NAAG's revised Guidelines do not mention the recently-withdrawn DOJ Guidelines and the rhetoric that filled NAAG's earlier versions has been excised. The Guidelines are a significant reaffirmation of the primacy of the role of the states in the area of vertical restraints and will serve as a constant reminder that any risk assessment necessarily involves considerable knowledge of how a particular state Attorney General will evaluate the matter.

The Guidelines explain the enforcement policies concerning three categories of vertical restraints. First, resale price maintenance agreements ("RPM") also called vertical price-fixing where, for example, a manufacturer and retailer agree that products will be sold at retail prices at or above a fixed level and that non-complying retailers will be denied the manufacturer's merchandise. RPM agreements are *per se* violations of the Sherman Antitrust Act and many state antitrust laws, which means that proof of the agreement is a violation in itself not subject to any defense of economic or market justification. RPM agreements have and may be prosecuted as criminal violations of the antitrust laws.

In the second category, non-price vertical restraints, are practices such as exclusive distributorships, whereby a manufacturer grants certain distributors territorial monopolies, that is the exclusive right to wholesale a product within a defined geographic area. The legality of this type of vertical restraint is determined under a so-called "rule of reason" analysis which measures the actual competitive effects of the restraint in the marketplace.

In the third category are "tying arrangements" which condition the sale of one product or service on the purchase of a second distinct product or service. Certain tying arrangements are *per se* unlawful, while others are subject to a "rule of reason" test of their legality.

A summary of the major elements of the NAAG Vertical Restraints Guidelines, including the revisions, is as follows:

1. The NAAG Guidelines treat RPM agreements as *per se* unlawful in accord with settled Supreme Court law. The court first adopted this rule in a 1911 decision, *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, and most recently upheld its validity in the 1984 decision of *Monsanto Co. v. Spray-Rite Service Corp.* (NAAG Guidelines § 2.1).

2. The NAAG Guidelines make clear that intrabrand horizontal conspiracies (such as a price-fixing agreement among competing retailers of a particular manufacturer's product) are *per se* unlawful, in accordance with settled Supreme Court law announced in cases such as *United States v. General Motors*, 384 U.S. 127 (1966) (NAAG Guidelines § 2.2).

3. The NAAG Guidelines employ a rule of reason analysis for assessing the legality of non-price vertical restraints which takes into consideration the effect these restraints have on intrabrand competition, *i.e.*, the competition between sellers of the same brand of a product. The Supreme Court's 1977 decision in *Continental T.V. Inc. v. GTE Sylvania, Inc.*, requires anticompetitive intrabrand effects to be balanced against any pro-competitive <u>interbrand</u> effects (competition between different brands) in determining whether a non-price vertical agreement has unreasonably restrained trade (NAAG Guidelines §§ 3 and 4).

4. The NAAG Guidelines employ a rule of reason test which seeks to measure any and all ascertainable interbrand effects of a non-price vertical restraint, whether they be pro-competitive or anticompetitive (NAAG Guidelines §§ 4 and 4.15).

5. The NAAG Guidelines deal with tying arrangements in accordance with the Supreme Court's ruling in *Eastman Kodak Co. v. Image Technical Services, Inc.* (NAAG Guidelines § 5).

6. The NAAG Guidelines are a statement of the general enforcement policy of the state attorneys general to be supplemented in each state according to variations in state law, federal circuit law and individual prosecutorial prerogatives. The NAAG Guidelines are not intended as either a general *amicus curiae* brief or as a comprehensive restatement of existing case law (NAAG Guidelines § 1).

7. The NAAG Guidelines incorporate by reference the market definition methodology of the NAAG Horizontal Merger Guidelines in appropriate rule of reason cases (NAAG Guidelines § 6).

NAAG VERTICAL RESTRAINTS GUIDELINES
EXECUTIVE SUMMARY

The Vertical Restraints Guidelines of the National Association of Attorneys General (NAAG) will be presented for adoption by the Attorneys General at the Association's spring meeting, March 26-28, 1995, in Washington, D.C. The Guidelines explain the general enforcement policy concerning vertical restraints of the fifty-five state and territorial Attorneys General and the Corporation Counsel of the District of Columbia, who comprise NAAG's membership. Individual Attorneys General may vary or supplement this general antitrust enforcement methodology in the exercise of their individual prosecutorial discretion or to account for differences in state antitrust laws and variations in precedents among the federal circuits. In most states, the Attorney General is the primary or exclusive public enforcer of state antitrust law. The Attorneys General also represent their states and consumers who live in their states in federal antitrust litigation.

Vertical restraints are arrangements among businesses operating at different levels of an industry, *e.g.*, between a manufacturer and a distributor, or between a wholesaler and a retailer. These restraints can govern the price or conditions at which firms may buy, sell or resell goods and services. These Guidelines provide a framework for state antitrust enforcers to evaluate vertical restraints and determine their legality and likely effect on competition. Because of the extraordinary diversity of vertical restraints, the Guidelines do not purport to define the legality of each type of restraint in every context.

The Guidelines are designed to serve three primary purposes. First, they are a framework for analyzing vertical restraints that relies on market realities and case law rather than speculation and pure theory. Second, they inform the business community of the substantive standards used by the Attorneys General to review and, when appropriate, challenge vertical restraints. Finally, they articulate the analytical methodology the states will apply in determining whether a particular restraint is unlawful.

The primary purposes of the *revision* were to articulate the states' methodology for evaluating vertical restraints, to clarify the types of evidence the states would use when evaluating non-price restraints under the rule of reason, to adopt market definition methodology consistent with the methodology set forth in the Horizontal Merger Guidelines of NAAG adopted on March 30, 1993, and to underscore the primacy of facts over theory in vertical restraints analysis.

On January 23, 1985, the United States Department of Justice issued its Vertical Restraints Guidelines. These Guidelines were cast in terms of enforcement policy, although the Justice Department had not challenged a vertical restraint for five years prior to the issuance of those Guidelines. NAAG first issued Vertical Restraints Guidelines on December 5, 1985. In 1987, the NAAG Guidelines were revised to reflect recent developments in the case law governing vertical restraints. In 1993, the United States Department of Justice withdrew its Vertical Restraints Guidelines and began to increase enforcement resources devoted to challenging vertical restraints.

Because US-DOJ withdrew its Vertical Restraints Guidelines, and because case law had changed, all states were invited to participate in a NAAG Guidelines Revision Committee, co-chaired by Assistant Attorney General Kevin J. O'Connor, Wisconsin, and former Assistant Attorney General Beth Farmer, New York. Several states participated as members of the committee: Assistant Attorney General Thomas Greene and Deputy Supervising Attorneys General Barbara Motz and Richard Light, California; Assistant Attorney General Steve Rutstein, Connecticut; Assistant Attorney General Sara Allen, Virginia; Assistant Attorney General Ellen Cooper, Maryland; Assistant Attorney General Suzanne Dallimore, Arizona; Assistant Attorney General Jim Donahue, Pennsylvania; Assistant Attorney General Doreen Johnson, Ohio; Assistant Attorney General Pamela Jones Harbour, New York; Assistant Attorney General Marta Lowy, Washington; Assistant Attorney General Mark Tobey, Texas. Professor Robert Lande, University of Baltimore School of Law; Professor Warren Grimes, Southwestern School of Law; and Professor Howard Marvel, Ohio State University, Department of Economics, provided invaluable assistance. In addition, Emily Myers, Antitrust, Insurance and Health Counsel at NAAG, provided significant substantive assistance and support for the revisions. Numerous other people in the federal agencies and the private bar, including the ABA Section for Antitrust, have provided helpful comments and suggestions.

The DOJ Vertical Restraints Guidelines, withdrawn by Assistant Attorney General Anne K. Bingaman in August 1993, were commonly understood to be a "political" document, designed to move the law in a particular direction. NAAG's 1985 and 1987 Guidelines were an attempt to state the law as it was understood at the time. NAAG's 1995 Guidelines do not mention the recently-departed DOJ Guidelines and commentary from NAAG's earlier versions has been excised. The Guidelines are a significant reaffirmation of the primacy of the role of the states in the area of vertical restraints and will serve as a constant reminder that any risk assessment necessarily involves consideration of how a particular state Attorney General will evaluate the matter.

The Guidelines explain the enforcement policies concerning three categories of vertical restraints. In the first category are resale price maintenance agreements ("RPM"), also called vertical price-fixing. If, for example, a manufacturer and retailer agreed that products will be sold at retail prices at or above a fixed level and that non-complying retailers will be denied the manufacturer's merchandise, that agreement would constitute RPM. RPM agreements are *per se* violations of the Sherman Antitrust Act and many state antitrust laws, which means that the agreement itself violates the law regardless of any defense of economic or market justification. RPM agreements have been and may be prosecuted as criminal violations of the antitrust laws.

In the second category, non-price vertical restraints include practices such as exclusive distributorships, whereby a manufacturer grants certain distributors territorial monopolies, that is, the exclusive right to wholesale a product within a defined geographic area. The legality of this type of vertical restraint is determined under a so-called "rule of reason" analysis which measures the actual competitive effects of the restraint in the marketplace.

In the third category are "tying arrangements" which condition the sale of one product or service on the purchase of a second distinct product or service. Certain tying arrangements are *per se* unlawful, while others are subject to a "rule of reason" test of their legality.

The major elements of the NAAG Vertical Restraints Guidelines, including the revisions, are as follows:

1. The NAAG Guidelines treat RPM agreements as *per se* unlawful in accordance with settled Supreme Court law. The court first adopted this rule in a 1911 decision, *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, and most recently upheld its validity in the 1984 decision of *Monsanto Co. v. Spray-Rite Service Corp.* (NAAG Guidelines § 2.1).

2. The NAAG Guidelines make clear that intrabrand horizontal conspiracies (such as a price-fixing agreement among competing retailers of a particular manufacturer's product) are *per se* unlawful, in accordance with settled Supreme Court law announced in cases such as *United States v. General Motors*, 384 U.S. 127 (1966) (NAAG Guidelines § 2.2).

3. The NAAG Guidelines employ a rule of reason analysis for assessing the legality of non-price vertical restraints. This analysis takes into consideration the effect these restraints have on intrabrand competition, *i.e.*, the competition between sellers of the same brand of a product. The Supreme Court's 1977 decision in *Continental T.V. Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977), requires anticompetitive intrabrand effects to be balanced against any pro-competitive <u>interbrand</u> effects (competition between different brands) in determining whether a non-price vertical agreement has unreasonably restrained trade (NAAG Guidelines §§ 3 and 4).

4. The NAAG Guidelines employ a rule of reason test which seeks to measure any and all ascertainable interbrand effects of a non-price vertical restraint, whether they be pro-competitive or anticompetitive (NAAG Guidelines §§ 4 and 4.15).

5. The NAAG Guidelines deal with tying arrangements in accordance with the Supreme Court's ruling in *Eastman Kodak Co. v. Image Technical Services, Inc.* (NAAG Guidelines § 5).

6. The NAAG Guidelines are a statement of the general enforcement policy of the state attorneys general to be supplemented in each state according to variations in state law, federal circuit law and individual prosecutorial prerogatives. The NAAG Guidelines are not intended as either a general *amicus curiae* brief or as a comprehensive restatement of existing case law (NAAG Guidelines § 1).

7. The NAAG Guidelines incorporate by reference the market definition methodology of the NAAG Horizontal Merger Guidelines in appropriate rule of reason cases (NAAG Guidelines § 6).

SUMMARY OF COMMENTS REGARDING NAAG VERTICAL RESTRAINTS GUIDELINES

At the 1994 summer NAAG Meeting, the NAAG Antitrust Committee preliminarily approved and directed that the draft NAAG Vertical Restraints Guidelines as revised be given the widest possible circulation among other enforcement agencies and the public. Following the NAAG meeting, red-lined copies of the proposed guidelines were circulated to a large number of academics, other enforcement agencies, the private bar and the public generally. In fact, the red-lined revisions were published in their entirety in the two major trade regulation reporting services.

Several sets of comments were received from a variety of sources including representatives of the private bar, academics and the business community. In important instances, the comments were quite supportive of the effort represented by the revisions. Because of the decision of the United States Department of Justice to withdraw the federal government's guidelines in this area in 1993, the FTC and the DOJ did not officially comment on these guidelines. However, informal comments were received from the federal agencies.

In addition, the comments offered numerous suggestions for improvement of the guidelines ranging from very general issues regarding the purposes of the antitrust laws to very specific technical issues.

What follows is a very general summary of the major comments and criticisms received (set out in bold-face type) in response to the draft. The changes, if any, made in response to each comment are described immediately following the comment. In addition, minor language changes were made in the final revision in response to suggestions that are not discussed here in detail.

SUMMARY OF COMMENTS

Sections 1 (Purpose and Scope of the Guidelines) and Section 2 (Categorization of Restraints): The guidelines do not provide enough guidance in the rule of reason context and maintain maximum prosecutorial flexibility to challenge certain restraints that are rarely found illegal.

One of the difficulties of establishing guidelines is that they can never anticipate every factual situation that might arise. This is especially true in the vertical restraints area. However, in response to the comments received, several changes have been made in direct response to comments. *See, e.g.*, sec. 4, below.

Section 2.1: The guidelines draw no distinction between minimum and maximum price-fixing and would be helpful if the guidelines indicated when maximum RPM schemes will be prosecuted.

Although the *Arco* decision raised questions about whether maximum RPM should be condemned in every instance, the law was not changed. The states have rarely been involved in such cases and have chosen not to expound in an area of primarily private litigation.

Section 2.1 (second paragraph): The guidelines should state the types of cases which would lead a state enforcer to bring criminal charges or should indicate that such criminal charges are rare.

It is difficult to anticipate every situation that might apply given that criminal charges would most likely be considered where there is a horizontal component to the vertical price-fixing or where the parties engaging in a clear case of vertical price-fixing by entities that had previously gained knowledge of the state's objection to a particular pricing practice. Having said this, it is appropriate to point out in the guidelines that criminal challenges to vertical price-fixing have been rare and the guidelines have been changed accordingly.

Section 2.1 (Treatment of *Sharp*): The more current law seems to require that the agreement to maintain prices affects a specific price not a price level. Opposing comments

suggest the guidelines should more explicitly condemn pricing rebate programs that condition rebates on adherence to minimum resale price and Cooperative Advertising Programs conditioned on adherence to Minimum Advertised Prices.

Due deference is given to the existing case law in footnote 15 which quotes from *Business Electronics, Inc. v. Sharp Electronics, Inc.*, 108 S. Ct. 1515, 1518 (1988) to the effect that an agreement on a "specific" price is not a necessary element of an RPM violation. The states have been extremely concerned about RPM agreements embedded in cooperative advertising programs and transfer price-rebate programs. We believe the language of the guidelines makes clear that we will take a lead role in investigating and challenging such practices where warranted.

Section 2.2 (first paragraph, first sentence): The guidelines inappropriately suggest that <u>all</u> horizontal restraints are *per se* illegal when *BMI* and *NCAA* cases suggest otherwise.

This is a fine point. Inserting the word "naked" before "horizontal" in the sentence in question should eliminate any suggestion that NAAG is misstating the law.

Section 2.2 (last paragraph): The guidelines allude to a differing standard for horizontal and vertical restraints even though the Court in *Matsushita* incorporated *Monsanto* standards into a horizontal analysis.

This point raises a matter of some controversy. Rather than pursue the question of the extent to which, if at all, it might be appropriate to apply *Monsanto* standards to various types of horizontal restraints, the sentence is eliminated since it is not essential to the point of the section.

Section 2.3 (Dual Distribution): The presumption concerning actual intent to affect horizontal competition is too strong and the guidelines do not cite to cases not finding horizontal restraints.

The guidelines do not attempt to cite all case law in an area. Rather, an attempt is made to cite to those cases which highlight the factor(s) being discussed. This section accurately states how the states will view these situations.

Section 3 (The Potential Effects of Non-Price Vertical Restraints of Trade): This section indicates a skeptical view of efficiencies and other rationales for vertical restraints.

By listing theoretical arguments for vertical restraints in this section, NAAG is acknowledging their importance to contemporary vertical restraints analysis. The skepticism expressed relates to using theory without appropriate factual underpinnings.

Section 4 (The Rule of Reason Analysis of Non-Price Vertical Restraints of Trade): The guidelines could provide more guidance if they established specific market share or market power thresholds and a "short form" rule of reason analysis.

The guidelines do suggest that market power plays a role in the analysis of vertical restraints. *See, e.g.*, sec. 3.3C. However, unlike horizontal mergers, market power can be a factor in the markets at each level of distribution. For example, manufacturers with little market power can face intense pressure from local retailers with market power to impose a restraint and, conversely, retailers with little market power may be forced to accept anticompetitive terms imposed by manufacturers with market power. Also, the impact of a particular restraint can be affected by other restraints in place in the industry. It is difficult to articulate market power screens that could accurately account for all permutations of the factual contexts in which non-price restraints arise. We note that none of those suggesting such screens offered specific suggestions as to what those screens should be.

Nonetheless, we have articulated a market power screen that should clarify the states' approach to those non-price vertical restraints least likely to cause concern. We note that the screen is consistent with the levels articulated in the 1993 NAAG Horizontal Merger Guidelines, which noted that the Attorneys General are unlikely to challenge mergers which do not significantly increase concentration.

Section 5 (Tying Arrangements): More emphasis should be given to efficiencies defenses.

The guidelines do not foreclose efficiencies defenses in appropriate cases. Other than citing to recent tying cases, it is difficult to articulate a better formulation of this issue given its fact-intensive nature. However, in order to clarify this point, Section 5.2C has been eliminated and the substance of that section has been incorporated in the general tying section, Section 5.2, to emphasize the importance of these types of concerns.

VERTICAL RESTRAINTS GUIDELINES

As Adopted by the
National Association of
Attorneys General

1. PURPOSE AND SCOPE OF THE GUIDELINES

These Guidelines explain the general enforcement policy of the fifty state attorneys general who comprise the National Association of Attorneys General ("NAAG")[1] concerning resale price maintenance agreements and non-price vertical restraints of trade subject to Sections 1 and 2 of the Sherman Act,[2] Section 3 of the Clayton Act[3] and analogous provisions of the antitrust laws of those States which have enacted them.[4]

In most states the Attorney General is the primary or exclusive public enforcer of the state's antitrust laws. The Attorneys General also represent their states and the natural person citizens of their states in federal antitrust litigation.[5]

Vertical restraints are arrangements among businesses operating at different levels of an industry, *e.g.*, between a manufacturer and a distributor or between a wholesaler and a retailer. They restrain the way, or price at which, these firms may buy, sell or resell goods and services. These guidelines focus primarily on resale price maintenance agreements, as well as exclusive dealing arrangements[6] and other foreclosure restraints such as tie-ins, which condition the sale of one product or service on the purchase of a second distinct product or service.

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[1] The Attorneys General of American Samoa, Guam, the Northern Mariana Islands, Puerto Rico and the Virgin Islands and the Corporation Counsel of the District of Columbia are also members of NAAG.

[2] Sherman Act Section 1, 15 U.S.C. § 1 prohibits concerted activity in restraint of trade. Section 2, 15 U.S.C. § 2 prohibits monopolization, attempts to monopolize and conspiracies to monopolize any part of trade or commerce.

[3] Clayton Act Section 3, 15 U.S.C. § 14 states in pertinent part "It shall be unlawful ... to lease or make a sale or contract for sale of ... commodities ... on the condition, agreement or understanding that the lessee or purchaser thereof shall not use or deal in the commodities of a competitor or competitors of the seller or lessor where the effect ... may be to substantially lessen competition or tend to create a monopoly in any line of commerce."

[4] Citations to the antitrust laws of the States are set forth in 6 Trade Regulation Reports (CCH) ¶ 30,000 *et. seq.*

[5] Clayton Act Section 4C, 15 U.S.C. § 15c states in pertinent part:

> (1) Any attorney general of a State may bring a civil action in the name of such State, as parens patriae on behalf of natural persons residing in such State, in any district court of the United States having jurisdiction of the defendant, to secure monetary relief as provided in this section for injury sustained by such natural persons to their property by reason of any violation of sections 1 to 7 of this title.

[6] Exclusive dealing arrangements, as the term is used in these Guidelines, include agreements that a seller deal exclusively with a particular buyer or group of buyers or that a buyer deal exclusively with a particular seller or group of sellers. Examples of exclusive dealing arrangements are exclusive distributorships (also referred to as "exclusive distribution territories"), requirements contracts and exclusive outlet provisions. These restraints, especially when air-tight, completely or substantially foreclose intrabrand competition.

Other vertical restraints such as location clauses, customer restrictions, areas of primary responsibility and profit pass-over arrangements may unreasonably restrain trade, but have less tendency to do so. For example, the imposition of areas of primary responsibility will allow a supplier to realize most of the objectives of an exclusive distributorship without extinguishing intrabrand competition. In particular cases these less suspect restraints may be imposed with anticompetitive intent or may unreasonably restrain trade. A location clause may effectively foreclose any intrabrand competition. A pass-over arrangement may have no purpose other than the penalization of extraterritorial sales with no countervailing interbrand benefit. See, e.g., *Eiberger v. Sony Corp. of America*, 622 F.2d 1068, 1076-81 (2d Cir. 1980). In such cases the analysis detailed in Section 4 will be applied.

These guidelines embody a general enforcement policy of NAAG and its members. Individual Attorneys General may vary or supplement this general policy to allow for variations in precedents among the federal circuits, differences in state antitrust laws and the exercise of their individual prosecutorial discretion. The Guidelines are not a substitute for properly submitted *amici curiae* briefs, which focus on the facts of particular cases. The "rule of reason" inquiry which the Supreme Court requires to determine the legality of non-price restraints is complicated and contextual.[7] That is, the contours of the rule of reason inquiry appropriate for a particular vertical restraint will depend on specific market and industry factors not reducible to any broadly applicable formula. Attorneys General may file briefs *amici curiae* in vertical restraint cases where such participation is warranted or requested by any federal or state court.

The Guidelines serve two primary purposes. First, the guidelines clearly mark the boundaries between horizontal agreements and resale price maintenance agreements that are *per se* unlawful and those purely non-price vertical agreements subject to a rule of reason analysis. Second, the guidelines describe and explain the factors that are relevant to the Attorneys General in conducting a rule of reason analysis of a non-price vertical restraint.

Neither these guidelines nor any other generalized statement of enforcement policy can assure businesses that a particular restraint will or will not be held lawful in court. Real cases present market and industry variables too numerous to be measured adequately in general formulae. Furthermore, no public enforcement policy can or should inhibit private litigation. Private parties have been and will continue to be the primary enforcers of the antitrust laws. In many cases the superior knowledge and experience of business litigants may result in better enforcement decisions than can be made by prosecutors whose knowledge is based only on theory and inquiry. Finally, although federal and state enforcement agencies can characterize the law, it remains for Congress to make those laws and for the judiciary to interpret the law.

2. <u>CATEGORIZATION OF RESTRAINTS</u>

A literal reading of Section 1 of the Sherman Act would condemn all concerted activity which restrains trade or commerce among the States, including conduct as innocuous and necessary as a simple contract to sell and buy.[8] However, the Supreme Court has interpreted the prohibition of the Act to reach only those concerted restraints of trade which are "unreasonable."[9] After nearly a century of interpretation, the Court has further refined the doctrine prohibiting unreasonable restraints of trade into two broad categories of arrangements: those which are *per se* unlawful and those whose legality (reasonableness) are to be determined under the so-called "rule of reason" analysis. In the *per se* category are restraints of trade such as price-fixing, whose anticompetitive effects are so uniform and unequivocal that the Courts will condemn them without any inquiry into the actual economic effects of the practice in a given case. Restraints which are not *per se* unlawful are subject to a rule of reason inquiry into their expected or actual market effects. Among these practices are non-price vertical restraints.

The foregoing doctrines require a threshold determination of whether a restraint is *per se* unlawful or subject to the far reaching market effect analysis which is detailed below. *Per se* or rule

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It should be noted that no case has held that any non-price vertical restraint is *per se* lawful.

[7] *Continental T.V. Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977) ("*Sylvania*").

[8] *See*, *e.g.*, *United States v. Trans-Missouri Freight Ass'n.*, 166 U.S. 290 (1897).

[9] *Standard Oil Co. v. United States*, 221 U.S. 1 (1911).

of reason categorization will in turn often depend upon whether a restraint is horizontal[10] or vertical in nature, and if vertical, whether the arrangement restrains pricing decisions or non-price aspects of the marketing process. This initial characterization of restraints is especially important when firms engage in more than one restraint or when they exert pressure or coercion at one level of an industry that ultimately imposes a restraint at another level.

If it is unstructured, a full rule of reason analysis can be inherently cumbersome, protracted and imprecise. In addition to expressing a judgment on the social and economic value of certain restraints, *per se* rules provide the business community with the certainty and predictability that are conducive to rational decision making.[11] However, the distinctions between *per se* and rule of reason standards adopted in the Guidelines are rooted in settled case law and do not represent any independent policy choice between such rules.

2.1 Categorizing price and non-price vertical restraints

Resale price maintenance agreements ("RPM"), also called vertical price-fixing agreements, are *per se* unlawful and have been so since the 1911 Supreme Court decision in *Dr. Miles Medical Co. v. John D. Park & Sons Co.* 220 U.S. 373. *Dr. Miles* also discussed the *per se* illegality of single brand horizontal price-fixing arrangements and equated the conclusively presumed anticompetitive effects of both practices.[12]

RPM can be prosecuted as a crime under the federal antitrust laws. Although such criminal challenges have been infrequent, RPM may be prosecuted as such by the Attorneys General in appropriate cases where state antitrust laws provide for criminal sanctions.[13]

An RPM agreement is reached when two or more independent firms at different levels in the distribution system agree to fix, raise, lower, maintain or stabilize the price at which goods or services will be resold.[14] There need not be any agreement on specific resale prices or price levels.[15] A practice under which a supplier's obligation to provide some benefit to a distributor, when it depends at least in part, on the price at which the distributor resells the supplier's product, may be viewed as a type of RPM agreement.

Non-price vertical restraints may have the effect of raising the prices at which goods or services are resold. However, a purely non-price vertical restraint, such as an exclusive

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[10] Horizontal agreements restrain trade among competitors at the same level of an industry, *e.g.*, competing wholesalers agree to fix their prices.

[11] In *United States v. Topco, Inc.*, 405 U.S. 596, 609-10 (1972) the Court stated: "Without the *per se* rules, businessmen would be left with little to aid them in predicting in any particular case what courts will find to be legal and illegal under the Sherman Act."

[12] "And where commodities have passed into the channels of trade and are owned by dealers, the validity of agreements to prevent competition and to maintain prices is not to be determined by the circumstance whether they were produced by several manufacturers or by one, or whether they were previously owned by one or many." *Dr. Miles*, 220 U.S. at 408-09.

[13] Citations to the antitrust laws of the States are set forth in 6 Trade Reg. Rep. (CCH) ¶ 30,000 *et. seq.*

[14] *United States v. Parke, Davis & Co.*, 362 U.S. 29, 47 (1960).

[15] *United States v. Parke, Davis & Co.*, 362 U.S. 29 (1960). In *Business Electronics, Inc. v. Sharp Electronics, Inc.*, 485 U.S. 717, 722 (1988), the Supreme Court determined that to render illegal *per se* a vertical agreement between a manufacturer and a dealer to terminate sales to a second dealer, the first dealer "must expressly or implicitly agree to set its prices at some level, though not a specific one" quoting the decision below. 780 F.2d 1212, 1218 (5th Cir. 1986).

distributorship, should not be treated as an RPM agreement merely because it may have an effect on price.

A more significant issue of categorization is raised when a supplier and its distributors have adopted both RPM and other non-price vertical restraints of trade. While in such cases the RPM agreement is *per se* illegal, questions have arisen as to whether the non-price restraints should then also be treated as *per se* unlawful.[16]

The Attorneys General will treat the issue as one of fact, *i.e.*, are the non-price restraints adopted to reinforce or assure the success of the price-fixing arrangement or is such their predominant effect? If so, the non-price restraints will be treated as *per se* unlawful. In conducting the factual inquiry necessary to determine whether non-price restraints were adopted to reinforce an RPM agreement, the Attorneys General will be cognizant of several general principles germane to this issue. First, firms engaging in RPM are already willfully violating a long established and well understood aspect of the antitrust laws.

Second, the reselling parties to an RPM agreement have incentives to cheat on the conspiracy by engaging in indirect forms of price competition.[17] The adoption of non-price vertical restraints may help maintain the discipline and effectiveness of the RPM agreement.

Finally, it is widely recognized that one of the potential harmful effects of RPM is to help maintain a suppliers' cartel. The adoption of non-price vertical restraints, especially exclusive distributorships, may reinforce the cartel maintaining properties for which the RPM schemes were initially adopted.[18]

2.2 Categorizing horizontal and vertical restraints

In accordance with settled and longstanding Supreme Court precedent, the Attorneys General will treat all naked horizontal agreements to fix prices or allocate customers, markets or territories as *per se* violations of Sherman Act Section 1 and analogous state law provisions. The Supreme Court has held that both intrabrand and interbrand competition are protected by the law.[19] Accordingly, the Court has consistently held horizontal agreements *per se* unlawful whether the conspirators are competitors selling different brands or the same brand.[20]

An issue of categorization may arise when a manufacturer (or distributor) and dealers agree or form a combination to fix prices or price advertising and it appears that each dealer agrees to so restrict its pricing or price advertising upon the condition that other dealers act accordingly or with knowledge that other dealers are so acting. In *Business Electronic, Inc. v. Sharp Electronics, Inc.*, 108 S. Ct. 1515, 1525 (1988), the Court characterized such a combination as horizontal in nature.

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16 *Monsanto Co. v. Spray-Rite Service Corp.*, 465 U.S. 752, 759 n. 6 (1984).

17 These include rebates, the provision of free goods and tie-in sales, favorable credit terms, absorption of transportation costs and expanded warranties.

18 See Ornstein, *Resale Price Maintenance and Cartels*, 30 Antitrust Bulletin 401, 407 (1985) and Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. Econ. 86 (1960).

19 *Sylvania*, 433 U.S. at 51.

20 *United States v. General Motors Corp.*, 384 U.S. 127 (1966); *Dr. Miles*, *supra*, 220 U.S. at 408-09. *See also*, *United States v. Topco*, 405 U.S. 596 (1972) (An agreement among competitors effectuated by an association's licensing agreements will also be considered horizontal); *United States v. Sealy*, 388 U.S. 350 (1967) (An agreement among competitors effectuated by a manufacturer's distributor agreements will also be treated as horizontal).

Therefore, in accordance with the teaching of *Sharp Electronics*, the Attorneys General will evaluate vertical price fixing agreements and combinations to determine whether they are also properly characterized as being horizontal in nature.

2.3 Dual distribution

Dual distribution occurs when a supplier of a product also acts as a dealer of the product in actual or potential competition with independent distributors of the product. Because of the competitive presence of the supplier at the dealer level, issues of categorization arise when a dual distributing supplier imposes vertical restraints which diminish or limit its competition with independent dealers.[21]

If the restraint takes the form of a vertical price-fixing agreement, the categorization issue is less significant in the sense that both vertical and horizontal price-fixing agreements are *per se* unlawful.

The mere fact that a supplier is a dual distributor should not automatically cause a non-price vertical restraint to be characterized as a horizontal agreement. A dual distributing supplier may impose a vertical restraint with the intent that it efficiently organize its dealers to engage in interbrand competition and without primary regard to the supplier's presence at the dealer level. Such a restraint will be evaluated under the rule of reason analysis specified in Section 4.

If the intent or predominant effect of the restraint is to prevent competition for the firm in its dealer capacity, the restraint will be treated as horizontal in nature and effect. When actual intent to restrain competition for the firm acting as dealer is found, this factor will be dispositive.

The following factors will be evaluated by the Attorneys General in determining whether to treat a vertical restraint imposed by a dual distributor as horizontal:

1) Whether a high percentage of the brand's sales at the dealer level are made by company owned outlets.[22]

2) Whether the non-price restriction diminishes interbrand competition because it restrains competing dealers who sell both the supplier's brand and competing brands.[23]

3) Whether the competing independent dealers are also interbrand competitors of the firm at the supplier level.[24]

3. THE POTENTIAL EFFECTS OF NON-PRICE VERTICAL RESTRAINTS OF TRADE

[21] For example, the dual distributor may keep a certain class of customer for itself, *e.g.*, government contracts, or impose traditional exclusive distributorships by geographical territory.

[22] *See, e.g., Graphic Products Distributors, Inc. v. Itek Corp.*, 717 F.2d 1560 (llth Cir. 1983).

[23] *See, e.g., American Motor Inns, Inc. v. Holiday Inns, Inc.*, 521 F.2d 1230 (3rd Cir. 1975).

[24] *See, e.g., Hobart Bros. Co. v. Malcolm T. Gilliland, Inc.*, 471 F.2d 894 (5th Cir. 1973), *cert. denied* 412 U.S. 923 (1973).

In the 1977 *Sylvania* decision, the Supreme Court determined that the legality of non-price vertical restraints of trade would be judged under a rule of reason analysis, thereby abandoning the previous rule that such restraints were conclusively presumed to be unreasonable, *i.e.*, illegal *per se*. The basis of the Court's ruling was its recognition of a growing body of economic literature which had theorized that in certain situations vertical restraints might enhance efficiency and spur competition among manufacturers or suppliers of competing brands. The Court required a rule of reason inquiry to balance any pro-competitive interbrand effects against the diminution or elimination of intrabrand competition, which vertical restraints always intentionally cause.

3.1 Economic theories concerning the effects of vertical restraints

It is difficult to generalize about the application of economic theory in this area because markets often deviate from the model of perfect competition in significant ways. However, models which properly account for market variations can usefully inform policy and enforcement decisions provided fidelity to the facts is maintained when modelling assumptions are developed.[25] Models which do not account for the market imperfections likely to be present will often lead to inaccurate or incomplete enforcement decisions.

Application of the traditional model of perfect competition can be both inconclusive and flawed.[26] Similarly, the wholesale application of vertical integration theory to the analysis of vertical restraints can be misleading.[27] It must also be recognized that those theorists who extol the efficiency enhancing properties of vertical restraints often premise such support on the assumption that a given market will <u>ultimately</u> expunge vertical restraints which decrease efficiency and are anticompetitive. But this is only likely to happen if the market workably conforms to certain assumptions underlying the model of perfect competition. These assumptions include, for example, that consumers make rational decisions based upon perfect knowledge of the marketplace, without the distortions introduced by misleading or misinformative advertising or market power at the producer or retailer level. Today's markets rarely comport with this ideal situation. Indeed, if markets were perfectly competitive in this sense, producers and retailers would have no incentive to adopt vertical restraints to certify quality, prevent free-riding or induce retailers to undertake greater promotional effort.

Furthermore, the view that markets will expunge market inefficiencies in the long run is nothing more than an extension of the observation that the market will ultimately destroy all cartels, all monopolies and all collusion. However, the Congress and state legislatures have adopted

[25] For example, the existence of market imperfections can cause many consumers to be unaware of either the existence of certain options or the fact that these options are cost effective substitutes for the product in question. *See Eastman Kodak Co. v. Image Technical Services, Inc.*, 112 S. Ct. 2072, 2086 (1992). *See* Lande, *Chicago Takes it on the Chin: Imperfect Information Could Play a Crucial Role in the Post-Kodak World*, 62 Antitrust L. J. 193 (1993).

[26] Grimes, *The Seven Myths of Vertical Price Fixing: The Politics and Economics of a Century-long Debate*, 21 S.W.U. L. Rev. 1285 (1992).

[27] Scherer, *The Economics of Vertical Restraints*, 52 Antitrust L. J. 687 (1983). Vertical integration theory, in this context, deals with potential gains in efficiency which result when, for example, a supplier becomes its own dealer or a dealer its own supplier.

antitrust laws because they were unwilling to wait for ultimate market cure and the inefficiency and consumer welfare losses attendant upon waiting for this lengthy process to run its course.[28]

3.2 Pro-competitive effects of non-price vertical restraints

Non-price vertical restraints of trade can enhance efficiency and consumer welfare in a number of ways.[29] The Attorneys General will consider these benefits only if the parties demonstrate that these benefits are likely to exist, that they will be significant in magnitude, that they will outweigh all of the anticompetitive effects of the restraints, and that the benefits will be passed on to consumers. The Attorneys General will not presume that such benefits are present. Although there are numerous variations to each of these theories, the principal theories are as follows.

3.2A Increasing interbrand competition

By diminishing or extinguishing intrabrand competition, a supplier may provide existing or new dealers with the incentive to devote additional effort to advertising, services and other forms of product enhancement and differentiation. These additional services may enable the product to compete effectively in the interbrand struggle, even as it diminishes intrabrand competition.

This argument is premised, in part, on the assumption that a rational supplier acting unilaterally may have no interest in strengthening the power of its dealers, and in some sense, his interests are consistent with ultimate consumers. Therefore, when a vertical restraint is unilaterally imposed and enhances dealer power it may be intended to strengthen the product in the interbrand market.[30]

3.2B Eliminating free-riding

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[28] The "long run" is loosely defined as the period of time necessary for effective entry to occur. Depending on the nature of the industry and the magnitude of entry barriers, this could mean from several months (*e.g.*, service industry with minimal capital and skill requirements) to many years (*e.g.*, capital intensive manufacturing or services that require highly specialized skills).

[29] The theorists who contend that vertical restraints increase efficiency are usually referring to allocative efficiency or "Pareto efficiency." Perfect allocative efficiency is a state of equilibrium on the so-called "utility-possibility frontier" in which no person can be made better off without making someone else worse off. Allocative efficiency can be achieved in an economy with massive inequities of income and distribution, i.e., 1% of the population can receive 99% of the economy's utility and 99% of the population can receive 1%. In contrast to the concept of allocative efficiency is "production efficiency." This type of efficiency is achieved by minimizing the costs of producing a given unit of a good or service.

[30] Recent empirical studies have cast some doubt on the oft-stated generalization that the net welfare effect of lessening intrabrand competition will be favorable. Mueller, *The Sealy Restraints: Restrictions on Free Riding or Output?*, 1989 Wis. L. Rev. 1255 (1989) (elimination of vertical restraints produced lower retail prices and higher output); Steiner, *Sylvania Economics - A Critique*, 60 Antitrust L. J. 41 (1991) (elimination of resale price fixing in two industries, toys and jeans, produced lower prices and higher output). These and similar studies suggest that producers have little incentive to impose vertical restraints on major categories of products enjoying substantial brand loyalty because downstream players will want to carry products that the consumers will select regardless of any downstream promotion. In these situations, it is likely that vertical restraints reflect "the triumph of retail leverage over common producer and consumer interests in a more competitive retail segment." Grimes, *supra* note 26, at 1305.

A second theoretical benefit resulting from vertical restraints may be the reduction of "free-riding." Free-riding is said to occur when discount or off-price dealers, who neither advertise, service or otherwise enhance a product, reap the benefits of such services performed by other dealers who must charge a higher price for the product. Similarly, "vertical or interbrand free-riding" occurs when a dealer utilizes the services provided to it by one manufacturer to sell the products of another manufacturer. An exclusive dealership may prevent such activity from occurring and thereby induce retailers to undertake a host of pre and post-sale service and promotional activities.

The free-ride phenomenon is much disputed among theorists, especially with regard to certain products for which servicing or product enhancement is highly unlikely.[31] Others have argued that free-riding could be eliminated through less restrictive means such as contract provisions or promotional fees.[32] Also, some have argued that retailer promotional activities can be misleading especially, where consumers assume that the retailer is neutral as to various brands.[33]

3.2C Retailer certification of quality

Certain retailers develop reputations for only carrying high quality products. Consumers may rely on such retailers to in effect "certify" that products they carry are of high quality thereby reducing consumer search costs. In some cases, the certification process can be costly to the retailer. Hence, retailers may be less likely to carry or "certify" a producer's product where other retailers are permitted a free-ride on the certifying retailer's efforts.[34]

Although the argument may have validity in some markets, it relies on the assumption that consumers are unable to evaluate product quality. Only where such certification serves as a surrogate for accurate, relevant product information may consumers benefit sufficiently to offset the likely adverse impact from reduced intrabrand competition caused by such restraints.

Also, quality certification can often be achieved more efficiently through producer-level image advertising or directly purchased through promotional fees.[35]

3.2D New entry

Finally, in some circumstances a vertical restraint may facilitate the entry of a new product into the market. An exclusive distributorship may give dealers the incentive to carry and promote a new product and assure a level of advertising or servicing necessary to win acceptance for a new

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[31] *See*, *e.g.*, Scherer, *supra* note 27, at 694; Marvel & McCafferty, *Resale Price Maintenance* (Ohio State University, Oct. 1982). "In many cases, the results of the search [for additional dealer services] have been fruitless, even ludicrous; and as a consequence have led many to question whether special services can explain the incidence and use of RPM." *See also*, Mueller, *supra* note 30; Marvel & McCafferty, *Resale Price Maintenance and Quality Certification*, 15 Rand J. Econ. 27 (1984).

[32] *Id.*

[33] *See* Grimes, *Spiff, Polish and Consumer Deception: Vertical Price Restraints Revisited*, 80 Cal. L. Rev. 817 (1992).

[34] Marvel & McCafferty, "Resale Price Maintenance and Quality Certification," 15 Rand J. Econ. 346 (1984).

[35] *See* Grimes, *supra* note 33.

product. As with the foregoing potential benefits of non-price vertical restraints, this benefit is not presumed. Their existence or likelihood must be demonstrated.

3.3 Anticompetitive effects of non-price vertical restraints

3.3A Elimination of intrabrand competition

The most obvious and inevitable effect of most non-price vertical restraints of trade is the diminution or elimination of intrabrand competition. Intrabrand competition can be a strong counterweight to limited interbrand competition. As previously discussed, the Supreme Court has clearly held that the antitrust laws protect this kind of competition and require a balancing of anticompetitive effects in the intrabrand market against any pro-competitive interbrand effects in determining the legality of a restraint.

3.3B Facilitation of collusion

A second possible anticompetitive effect of vertical restraints is the facilitation of collusion among suppliers and or dealers, when certain market conditions exist.

When most or all of the competing suppliers in a concentrated industry limit the number and geographical reach of their dealers, a dealer's cartel will be shielded from competitive prices from outside the cartel's region. Similarly, direct collusion among suppliers or collusion with dealers acting as surrogates is facilitated. Furthermore, the widespread use of such restraints facilitates the policing of a conspiracy, by strictly controlling the number of outlets that must be monitored for compliance.

3.3C Exclusion of competitors

Vertical restraints can raise entry barriers, erect new barriers and force competitors to operate inefficiently. When the dominant firms in a concentrated market bind available dealers to exclusive dealing arrangements, rivals of the dominant firms or potential entrants may have difficulty arranging for the distribution of their products. Potential entrants may be forced to enter the market at two levels rather than one, making entry significantly more costly. Existing competitors may be forced to vertically integrate or find new independent dealers. Either option may be more costly than distributing through the now foreclosed dealers.

A firm may contract for the exclusive right to purchase an important component in the manufacturing or distribution process. If the exclusive arrangement leaves insufficient quantities of the important component for competitors, potential or existing, entry barriers may be raised and costs of production increased. This will occur if the competing firms must integrate into the production of the component, and this is more costly, or if they are forced to substitute a less cost-effective or suitable component.

3.3D Allocative inefficiency from retail promotion induced by vertical restraints

When vertical restraints operate at the retail level and affect multi-brand retailers, these retailers have a financial incentive to promote a particular brand over others that they sell. Consumers, not knowing this, may continue to regard the multi-brand retailer as an objective advice-giver. The consumer may buy a brand not consistent with the consumer's preferences because of this promotion, a result inconsistent with the allocation of resources expected from a workably competitive market.

3.3E Reinforcement of oligopolistic behavior

In an oligopolistic market the previously discussed tendency of vertical restraints to facilitate overt collusion and raise entry barriers, also facilitates tacit collusion and reinforces patterns of consciously parallel behavior. Also, erosion of the oligopoly is retarded by making entry more costly.

4. THE RULE OF REASON ANALYSIS OF NON-PRICE VERTICAL RESTRAINTS OF TRADE

The decision to challenge a particular vertical restraint will be made after an analysis of the arrangement under the factors listed in this section and in Section 3 above. Although certain factors may be deemed more important in certain contexts, no single factor is dispositive. That is, there are no arbitrary cutoff points which can be said to assure that a restraint will or will not definitely be challenged. Such arbitrary tests, while useful in other contexts, and appealing because of the certainty they seemingly provide, are of little utility in reaching a reasoned determination or enforcing the law in this complex area.

4.1 Intrabrand effects

The factors in Section 4 have as their primary function, the prediction or assessment of the competitive effects of a vertical sales restraint in the interbrand market, although certain intrabrand effects will be noted. Vertical restraints are always intended to diminish or eliminate intrabrand competition. Where a specific restraint or attribute of a restraint tends to ameliorate these anticompetitive intrabrand effects, it will be noted.

4.2 Fungible and highly differentiated products

The competitive effects of a particular restraint will be influenced by whether the product involved is fungible or highly differentiated.

High product differentiation produces less elastic demand for the product in the near term, that is the demand is less sensitive to price changes in the short run. The dealers of such a product may be able to raise prices significantly without customer defection to other brands. In essence, high product differentiation produces greater market power.

It has also been demonstrated that the additional services, advertising or product differentiation which may result from restraints such as territorial restrictions may only be valued by the marginal consumers of established, highly differentiated products. If some consumers of the product do not want the additional service or place little value on it, the loss of consumer welfare to such consumers may well exceed any welfare gains to marginal consumers.[36]

In contrast, a fungible product, or one for which there is easy and suitable substitution, will produce a market with highly elastic demand and vigorous interbrand price competition. However, fungible products are subject to less product enhancement by dealers. The prevention of "free-riding" is generally inapposite. Furthermore, a restraint which truly induces additional dealer services may cause interbrand free-riding effects, an inefficient result. Collusion is also more likely to be successful in the markets for fungible products, but this effect will depend upon market concentration and coverage factors discussed in Section 4.8.

4.3 Multiple exclusive distributorships

If a dealer is granted the exclusive right to distribute two or more competing products in the same geographical territory, interbrand competition is substantially eliminated for those brands. The greater the number and market share of brands exclusively distributed by a single dealer with a territorial monopoly the greater will be the anticompetitive effect in the interbrand market. Collusion will also be greatly facilitated.

4.4 Dealer involvement in the imposition of a restraint

The unilateral imposition of a vertical restraint by a supplier may be motivated by the desire to enhance the competitiveness of a product in the interbrand market.

An intrabrand agreement among dealers which is imposed upon or adopted and policed by a supplier is *per se* unlawful, as discussed in Section 2.2.

However, between unilateral imposition of a vertical restraint and horizontal conspiracy, there are varying levels of dealer participation or coercion which may cause a supplier to impose a restraint. This participation is a relevant factor in assessing whether a particular restraint is likely to serve any procompetitive purpose in the interbrand market.

At one extreme, a supplier may have received sporadic, uncoordinated requests by individual dealers that a restraint be imposed. At the other end of the spectrum, a group of dealers may have actually engaged in an intrabrand conspiracy by jointly petitioning a manufacturer to impose a restraint.

The Attorneys General will consider the role that dealer pressure played in the institution of a vertical restraint. It will be considered in terms of its magnitude, frequency and the level of its coordination. The more frequent and more forceful the pressure, the less likely that the supplier

[36] Comanor, *Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy*, 98 Harvard L. Rev. 983 (1985). *See also*, Spence, *Monopoly, Quality and Regulation*, 6 Bell J. Econ. 417 (1975).

imposed the restraint for pro-competitive reasons and the more likely that the supplier merely bowed to dealer pressure, motivated by the dealers' shortsighted desire to reap monopoly profits.[37]

The phenomenon of dealer pressure that has, arguably, not reached the point of conspiracy, also occurs among multibrand dealers.[38] When such pressure leads to the adoption of vertical restraints by many suppliers, not only is the pro-competitive interbrand rationale absent, but results similar to interbrand collusion are achieved.[39]

4.5 The requirement and performance of additional services under vertical restraints

One rationale for the imposition of vertical restraints is that they are necessary to induce and assure the advertising, services and product enhancement which will allow a product to compete effectively in the interbrand market.

The Attorneys General will consider whether a supplier imposing a vertical restraint requires dealers to perform additional advertising, pre-sale demonstration, post-sale servicing and other forms of product enhancement and monitors compliance with those requirements. The nature of the additional services will also be considered.[40]

In the case of a restraint which has already been in effect, the Attorneys General will also assess to what extent these additional services were actually provided after the restraint was imposed.

4.6 Natural longevity v. contractual longevity of restraints

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[37] In *Monsanto*, the Court recognized the prevalence and legitimacy of communications between dealers and suppliers which inform a supplier whether or not there is compliance with a vertical restraint which the supplier had independently imposed. 465 U.S. at 762. This practice, where dealers monitor compliance with a restraint unilaterally imposed by the supplier, contrasts sharply with dealer pressure aimed at persuading or coercing a supplier to impose a restraint which will enhance the dealers' power, arguably at the expense of both the supplier and consumer. Restraints imposed because of such pressure may also have consequences similar to an interbrand agreement. For example, dealer pressure may cause a supplier of Product A to grant territorial exclusivity, thereby eliminating competing dealers who discount. Using this as a model, the dealers of Product B exert pressure for the imposition of similar exclusive distributorships. B is less likely to resist once its competitor has adopted the restraint. This process can continue until a significant portion of the market is covered by the restraint. Discounts are eliminated over a broad range of the market. The outcome is similar to an interbrand agreement. This "leadership" pattern, observed recently by the Attorneys General in several industries is not evidence of free markets functioning, but rather the political economy of groups or institutional behavior. The interbrand effect is especially likely if the dealer pressure emanates from trade associations whose members are interbrand competitors.

[38] For example, a group of large multibrand retail or wholesale chains meet and announce individually that they will only deal with suppliers who employ certain restraints. The restraints are thereafter imposed unilaterally by several suppliers.

[39] This discussion is distinct from the evidentiary standards utilized in proving actual intrabrand or interbrand agreements. *See* page 11, *supra* and *Monsanto*, 465 U.S. at 762-768.

[40] For example, if a supplier requires its dealers to buy shirts for local sports teams or to display its product in a certain showcase, the requirement may have little procompetitive benefit, such as, providing consumers better quality, a greater selection, or lower prices. However, the anticompetitive consequences of such a restraint, if any, may also be insignificant.

Natural market forces tend to expunge anticompetitive restraints. Therefore, in certain circumstances, the fact that a particular type of restraint has existed for a long time may prove that the restraint is not anticompetitive. On the other hand contractual provisions can keep anticompetitive restraints in force for a longer period than natural market forces would normally permit. Thus the fact that a particular type of restraint has existed for a long time can lead to two inferences:

1) that the restraint has existed a long time because it is generally procompetitive.

2) that the restraint is anticompetitive but successful and has been kept in place by long contractual periods and its exclusionary effect.

The Attorneys General will look carefully at market structure, the length of contract terms containing restraints and the ease of entry and exit from the market to determine which of the above inferences is appropriate.

4.7 <u>Concentration and coverage of the markets</u>

The tendency of vertical restraints to facilitate collusion among suppliers or dealers and exclusion of rivals increases with the concentration of the markets and coverage[41] of a particular restraint or different restraints having the same effect.[42] The Attorneys General will attempt to ascertain the concentration levels in the supplier and dealer markets and the market shares of firms employing the vertical restraint under scrutiny.

A determination of the extent to which a vertical restraint may facilitate collusion or exclusion will be made in accordance with the following precepts:

(a) If the supplier and dealer markets are not concentrated or the restraint is not utilized by firms with a large market share, collusion or exclusion is not significantly facilitated by the restraint.

(b) If either the dealer or supplier market is concentrated and highly covered by a restraint, collusion in the concentrated market will be facilitated. The absence of exclusion will not be considered an ameliorating factor, since the threat of a new entrant into a concentrated market does not prevent collusion.

(c) If one market is both highly concentrated and highly covered by a restraint and the other market is highly covered, collusion and exclusion will be facilitated in the first market.

(d) If both supplier and dealer markets are concentrated and covered by a restraint, collusion and exclusion will be facilitated in both markets.

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41 "Coverage" of a restraint refers generally to the percentage of sales in a market sold subject to the restraint in question.

42 For example, one firm may adopt exclusive distributorships. A competing firm adopts coterminous areas of primary responsibility and simultaneously adopts a profit or warranty pass-over arrangement which penalizes extraterritorial sales so harshly that the restraints have the same effect as exclusive distributorships.

The higher the actual concentration and coverage figures, the more pronounced will be the tendency to facilitate collusion and/or exclusion. There are various ways of measuring concentration and coverage which can be utilized when accurate market share data is available.[43]

Certain specific values have become associated with the concept of a "concentrated industry."[44] While these are useful guideposts, no hard and fast cut-off point will be applied in these Guidelines. Nevertheless, the Attorneys General will be unlikely to challenge a non-price vertical restraint when the markets involved, in all of the relevant levels of distribution, have HHI's less than 1000, or when all of the relevant parties to a non-price vertical agreement have less than 10 percent of their respective markets.

4.8 Indicia of tacit collusion or conscious parallelism

Related to the tendency of widely adopted vertical restraints to facilitate collusion and exclusion in concentrated markets is their tendency to reinforce patterns of consciously parallel or tacitly collusive behavior in oligopolistic markets.

When a restraint covers a high percentage of an oligopolistic market, it will tend to reinforce anticompetitive oligopolistic behavior. In turn a market will be considered oligopolistic if it is highly concentrated and some or all of the following practices are common to the industry:

1) Price leadership
2) Pre-announced price changes
3) Price rigidity in response to excess capacity or diminished demand
4) Public pronouncements and discussions of the "right price" for the industry[45]
5) Systematic price discrimination.
6) Past collusion regarding prices or marketing practices.

4.9 Entry barriers

Barriers to enter the industry where the restraint is imposed will be evaluated.

A vertical restraint may be utilized by an entrant to encourage dealers to distribute a new product and elicit the level of advertising and service essential to assure the product's acceptance with consumers. These are procompetitive goals.

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[43] For these purposes, the market share of a supplier will be its share of all sales to firms in the dealer market under scrutiny. Furthermore, vertically integrated firms will be included in the market share calculations and deemed to be employing the restraint. Partially integrated firms will be included and deemed to be employing the restraint for that percentage of products transferred internally to the dealer market rather than purchased in the market. Coverage may be computed by summing the market shares of all firms employing the restraint in the suppliers' market ("SM") and dealers' market ("DM"). Concentration can be measured by use of the Herfindahl-Hirschman Index ("HHI") which is the sum of the squares of the market shares of all of the firms in the industry.

[44] For example, a four firm concentration ratio of 60% or an HHI in the range of 1000-1800 for a concentrated market and above 1800 for a highly concentrated market . See NAAG Horizontal Merger Guidelines at §§ 4.2, 4.3.

[45] Posner, *Oligopoly and The Antitrust Laws: A Suggested Approach*, 21 Stanford Law Rev. 1579 (1969).

As discussed in Section 4.9, widely adopted vertical restraints in concentrated industries may, however, facilitate exclusion by tying up available dealers or monopolizing a component necessary to manufacture or market a product.

The Attorneys General will also assess entry barriers in an industry which are unrelated to the restraint itself, because the length of time necessary for market forces to purge an anticompetitive restraint will be determined by such conditions.

The Attorneys General will be less likely to challenge a restraint deemed anticompetitive after full analysis, if entry barriers are low. Artificial barriers, such as government regulation and licensing, will also be considered because they may erect obstacles to entry which market forces are powerless to correct.

4.10 Effect on consumer choice

There is virtual consensus among economists that a competitive market will produce a wide range of price/quality options. Vertical restraints can increase or decrease the number of price/quality options. The Attorneys General will consider the actual or likely effect that a restraint has on such consumer choice in assessing a restraint.

4.11 Miscellaneous factors

In the assessment of particular restraints, additional miscellaneous factors may become relevant to the inquiry. Among these factors would be the regulatory climate in an industry, a history of collusion in the industry or evidence disclosing the actual competitive intent of the responsible officials of a firm imposing a vertical restraint.

5. TYING ARRANGEMENTS

Tying arrangements condition the sale of one distinct product or service ("the tying product") on the buyer's agreement to purchase a second distinct product or service ("the tied product") or agreement not to purchase the tied product or service from any other supplier.[46]

Some tying arrangements are explicit, but others must be inferred from inducements short of a formal requirement. For example, when a firm sells two products separately but offers a steep discount when both products are purchased, a tying arrangement may be inferred. Similarly, when a firm significantly curtails service of one product unless another product is purchased, fails to cooperate with the purchaser in other respects, or fails to offer the buyer new products unless it also buys the product in question, an effective tie may be inferred.

Tying arrangements can unreasonably restrain trade and lead to anti-competitive effects by permitting a firm to exploit a dominant position in the market for the tying product by diminishing competition on the merits in the market for the tied product.[47] Inferior tied products may be

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[46] *Eastman Kodak Co. v. Image Technical Services, Inc.*, 112 S.Ct. 2072, 2079 (1992).

[47] Tying also can enable a firm to engage in price discrimination. This has the effect of making certain customers (and consumers as a whole) pay more for their products. *IBM Corp. v. United States*, 298 U.S. 131 (1936). This transfer of

insulated from competition and entry of new competitors is made more difficult. In other cases, tying arrangements may represent an efficient means of packaging products or services which attract, rather than force consumers to purchase the tied products.

The Supreme Court has ruled on the characteristics which make a tying arrangement *per se* unlawful.[48] In cases where the tying arrangements are not deemed *per se* unlawful, an abbreviated form of the rule of reason analysis specified in Section 4 will be utilized to determine whether a particular arrangement will be challenged.

5.1 <u>Tying arrangements which are per se unlawful</u>

The Supreme Court held, and the Attorneys General will deem, a tying arrangement *per se* unlawful if it has the following characteristics:

1) The tying and tied products (services) are distinct;

2) The arrangement forecloses a "substantial volume of commerce" or there is a "substantial potential" of such impact on competition.[49]

3) The firm tying the products has sufficient "market power" in the tying product to make anticompetitive "forcing ... probable."[50]

5.1A <u>Distinct products</u>

The requirement that the tying and tied products be distinct is satisfied if the two products can be provided separately and there is a distinct demand for each of the products.[51] Distinct demand can be shown from actual separate sales or requests for such separate sales.[52]

5.1B <u>Impact on commerce</u>

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wealth from consumers to a firm with market power is an undesirable outcome that the antitrust laws were designed to prevent.

[48] *Jefferson Parish Hospital District No. 2 v. Hyde*, 466 U.S. 2 (1984). The above discussion and *Jefferson Parish* concern tying arrangements challenged under Section 1 of the Sherman Act. The standards applicable to tying arrangements challenged under Section 3 of the Clayton Act were discussed by the Supreme Court in *Times-Picayune Publishing Co. v. United States*, 345 U.S. 594 (1953).

[49] *Jefferson Parish*, 466 U.S. at 16.

[50] The Court has described this requirement as follows:

> "Per se condemnation--condemnation without inquiry into actual market conditions--is only appropriate if the existence of forcing is probable. Thus application of the per se rule focuses on the probability of anticompetitive consequences. Of course, as a threshold matter there must be a substantial potential for impact on competition in order to justify per se condemnation." *Jefferson Parish*, at 15-16.

[51] Evidence of two separate products with separate demands exists when two products are used in variable proportions. Goods used in variable proportions also can sometimes be the subject of a tie whose purpose is price discrimination. *See Jefferson Parish*, 466 U.S. at 13-15.

[52] The Court stated that "... the question whether one or two products are involved turns *not on the functional relation between them*, but rather on the character of the *demand* for the two items." *Jefferson Parish*, 466 U.S. at 19 (emphasis supplied).

The requirement that the arrangements have the potential for affecting a substantial amount of commerce or have actually foreclosed a substantial amount of commerce, is satisfied when it can be shown that substantial separate sales would occur absent the tying arrangement.[53]

5.1C Market power sufficient to make "forcing" a probable outcome.

The final requirement for *per se* treatment of a tying arrangement is that the firm possess sufficient "market power" in the tying product to create the probability that consumers will be forced to buy the tied product, thereby diminishing "merit" competition for sales of the tied product.[54]

Market power is sufficient to make forcing a probable outcome if the firm employing the arrangement has a monopoly over the tying product (including a patent), a dominant position in the market for the tying product or offers a "unique product that competitors are not able to offer."[55] Such market power can be present in aftermarkets where the seller has a relatively small share of the original equipment market, but substantial leverage in aftermarkets as the result of information problems.[56] Market power can additionally be inferred in part from a large defendant market share, or it can be present even if the defendant's market share is smaller due to the existence of significant market imperfections.[57]

In any event, actual proof of substantial anticompetitive forcing will satisfy the test of market power.

5.2 Analysis of tying arrangements under the rule of reason

When a seller employing tie-in sales has insufficient market power to "force" the purchase of the tied product, analysis under the rule of reason is required to determine whether the arrangement unreasonably restrains trade.[58] The analysis requires an inquiry into the effect of the arrangement on the quality, supply and demand for both the tying and tied products, but focuses primarily on the market for the tied product.[59] Efficiencies, business justifications,[60] and actual

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[53] This threshold requirement is distinct from the issue of "forcing." If the amount of commerce affected or likely to be affected is *de minimis*, a restraint will not be unlawful under a *per se* test, even if there is "forcing." Nor can it be held unreasonable under a rule of reason test. This requirement is analogous to the predicate in all Sherman Act cases that a "not insubstantial amount" of interstate commerce be affected.

[54] Forcing is not demonstrated merely by showing that a buyer formerly purchased the products separately or would do so if the products were not tied. Such purchases may be the result of the attractiveness of the items as packaged. Such proof is relevant to the issue of the probability of a substantial effect on commerce discussed in Section 5.1B. Forcing requires more, *i.e.*, the diminution or elimination of "merit" competition for sale of the tied product.

[55] 466 U.S. at 17, *e.g.*, unique real property.

[56] *Eastman Kodak Co. v. Image Technical Services, Inc.*, 112 S. Ct. 2072 (1992).

[57] *Eastman Kodak Co. v. Image Technical Services, Inc.*, 112 S. Ct. 2072 (1992), shows how imperfect information can enable a firm without a conventionally defined monopoly share to use a tying arrangement that prevents consumers from making optimal purchasing decisions. Market imperfections can substitute for traditional market share based market power and enable a firm in a market that otherwise appears competitive to harm consumers.

[58] As in *per se* cases, threshold findings of distinct products and probable or actual effect on a substantial amount of commerce must be made. See discussion in Sections 5.1A and 5.1B.

[59] For example, the Supreme Court indicated in *Kodak* that ties have the ability to obscure and complicate the buyer's

competitive intent, when ascertainable, will also be evaluated. Because many of the factors utilized in the analysis of other non-price vertical restraints have little relevance in analyzing the competitive consequences of tying, an abbreviated form of the analysis discussed in Section 4 will be applied.

5.2A <u>Degree of product differentiation of the tying product</u>

A product may not be so highly differentiated as to be "unique," (thereby not satisfying the market power test for *per se* treatment) yet be sufficiently differentiated so as to approach, but not reach, a position of "market power." The more highly differentiated a tying product, the more likely a tying arrangement will tend to diminish merit competition for sales of the tied product.

5.2B <u>Coverage and entry barriers</u>

If all or most of the firms in the market for the tying product adopt similar tying arrangements and the barriers for entry into that market are high, the arrangements will have a greater adverse impact on merit competition in the market for the tied product. This would also substantially limit buyer choice in terms of the number of packaging options. However, if as a result of the tying arrangement, the tying and tied products are now available in a greater variety of packages, separate or tied, buyer choice is increased and the tying arrangement may enhance consumer welfare.

6. <u>MARKET DEFINITION</u>

In analyzing purely non-price vertical restraints of trade in accordance with the factors discussed in Sections 4 and 5, the Attorneys General will utilize the market definition principles set forth in the 1993 Horizontal Merger Guidelines of the National Association of Attorney Generals. (*See* Sections 3.1, 3.11, 3.2 and 3.21 of the Guidelines.) The product and geographic market should be analyzed separately for each product subject to the restraint.

These market definition principles will be applied in most cases. However, as an alternative, the methodology for defining markets set forth in the 1992 DOJ-FTC Merger Guidelines may be used when such analysis is appropriate under the principles set forth in Section 3A of the 1993 Horizontal Merger Guidelines.[61]

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transaction thereby undercutting the welfare and efficiency benefits of competition. *See generally* Grimes, *Antitrust Tie-In Analysis After Kodak: Understanding the Role of Market Imperfections*, 62 Antitrust L. J. 263, 273-79 (1994); Lande, *supra* note 25.

[60] Efficiencies or business justifications, although easy to allege and difficult to prove convincingly, may be considered as a defense to a tying arrangement. *U.S. v. Jerrold Electronic Corp.*, 365 U.S. 567 (1961).

[61] Market realities, including imperfections, must be considered in defining relevant markets. *See Eastman Kodak Co. v. Image Technical Services, Inc.*, 112 S. Ct. 2072 (1992).